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William H. Gross: It's the housing market deflation

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It seems to me that the U.S. economy requires a new orthodoxy, a redirection from consumption toward the stabilization of the housing market and an emphasis on infrastructure. America's economy is faltering because of an exhaustion of free-market capitalism that has mutated in recent years to something resembling a pyramid scheme. Our levered, derivative-based financial system, seemingly so ascendant after the dot-com madness that preceded it, has met its match with the subprime lending and poorly structured, opaque mortgage-backed securities of today's marketplace.

The result has been a dangerous deflation in America's most important asset class -- housing. Preventing home prices from declining even further is job No. 1 for monetary and fiscal authorities. So far, only Fed Chairman Ben Bernanke seems to appreciate the necessity for timely, creative solutions. The Fed has cut interest rates twice in eight days, by one-half of a percentage point this week and by three-quarters of a percentage point at an unscheduled meeting last week, and implemented a revised discount window framework in the form of its newly created Term Auction Facility. This "TAF" is designed to lower risk spreads in the high-quality end of the credit markets, and so far it is succeeding. Yet monetary policy has its limits. It cannot make bad assets turn good, nor can it be expected to lower mortgage rates to a level necessary to engender the buying power that would clear the tracts of unoccupied homes and place a floor under the deflating prices feared by American homeowners.

The adjustable-rate mortgage, so dependent on lower short-term yields, is all but dead these days, thanks to increased regulatory scrutiny and the inevitability of future lawsuits. The heavy lifting, then, must be done by the 30-year mortgage, rates for which need to come down at least an additional percentage point before it can stop housing's deflation. With inflation higher than it was during the halcyon days of 2003-04, such a reduction is not likely even if Bernanke were to drop the Fed's target interest rate to its previous floor of 1 percent.

So we do need a fiscal helping hand, and one that is timely and targeted, but current stimulus legislation appears to be aimed in the wrong direction. Granted, a measure that President Bush and House leaders agreed to and that the House approved this week has a provision to allow Fannie Mae and Freddie Mac to back larger mortgages. But that would do little to help those Americans who purchased homes over the past five years and whose monthly mortgage payments are now substantially higher, as well as those people who are being forced out of their homes entirely. Granted, the bipartisan plan would put money into the hands of consumers, helping them pay overdue debt and regain some lost ground from bill collectors. The Senate's proposal to increase food stamp benefits may be helpful as well.

But the big problem with the proposed "stimulus" is that it is really directed toward consumption, not toward the housing deflation that threatens the U.S. economy. Our economic problem today resembles the Japanese property market crisis of the 1990s. What's needed is not just $600 checks that will flow into Wal-Mart (and then to the Chinese) but an expanded Federal Housing Administration program offering below-market, 30-year mortgage refinancings with minimal down payments, which the private market and Bernanke cannot provide.

Republican orthodoxy seems so intent on curtailing the past abuses of Fannie Mae and Freddie Mac that some politicians are looking past a government agency solution in their own back yard. Housing and our finance-based market mania got us into this mess. Housing and government-based financial solutions must begin to get us out of it.

Ultimately, America's economy will require more than a $150 billion shot in the arm to resolve its slow-growth predicament. One hopes that Americans will come to recognize that a better direction for our economy will be neither tax-based nor consumption-oriented. We have followed that path to our detriment in recent years. If government is ascendant vis-a-vis the hegemony of the private market, then it must invest more wisely than its economic partner has. For now, however, to be effective, the right temporary fix requires additional focus on where the damage lies -- and that is centered on our housing market deflation.